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Comprehensive Overhaul of Partnership Audit Regime

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By: Patrick B. Fenn, Stuart E. Leblang, Lewis J. Kweit, Howard Leventhal, Olivier De Moor

- Under the default method, any adjustment will be assessed and taxed at the fund level in the year of the adjustment and at the highest applicable tax rate. As such, absent a contrary arrangement, the current investors will indirectly bear the economic burden of any tax collected, regardless of whether they were investors in the fund in the reviewed year (i.e., the year that is under audit). Investors would not be jointly and severally liable for fund-level deficiencies. The amount of fund-level liability may be modified if the fund can demonstrate that certain investors in the reviewed year filed amended tax returns and paid any associated tax liability, or that a lower tax rate applies to specific investors (including tax-exempt investors).
- Under an alternative method, a fund may elect to issue revised K-1s to its investors in the reviewed year and cause such investors to take into account any adjustments, as well as any collateral impact on tax attributes, and pay the calculated amount due on their tax returns in the year of the adjustment. These investors would also incur a two-percentage point increase on the interest rate on their underpayment of taxes. However, no tax would be assessed at the fund level.
- A fund with 100 or fewer partners can elect out of the regime, provided that no partner is treated as a partnership for U.S. federal income tax purposes.
- Existing statutory requirements to notify investors of certain fund-level audit activity and investor rights to participate in fund-level proceedings are repealed. Thus, under the new regime, the fund will generally have full authority to settle tax disputes affecting all investors (which represents a significant change from the existing regime).

- A fund will no longer need a “tax matters partner” (TMP) and instead will designate a “tax representative.” The tax representative must have a substantial U.S. presence, but no longer needs to be a partner or member.
- The new regime applies to taxable years beginning in 2018, although funds may elect to apply the new regime for taxable years beginning before 2018 but after the date of enactment.

Open-ended investment funds and closed-end investment funds operating beyond 2017 should consider the following:

- Update the fund’s governing documents, including LPAs and subscription documents, to permit an equitable allocation of historical tax liabilities and/or obtain appropriate indemnities, and to preserve the flexibility to require LPs to file amended returns and pay any associated tax liability.
- Review withdrawal mechanics to protect the fund’s potential exposure with respect to audit activity (e.g., using an escrow, LP clawback or special liquidation interest).
- Assess potential impact on net asset value, performance and management fee calculations and financial statements.
- Add a risk factor that the fund may be exposed to entity-level taxation upon audit as a material consideration in PPMs and other investor documentation.
- Increase efforts to prepare for IRS audits, since it is reasonable to anticipate that there will be an uptick in IRS audit activity.
- Expect additional diligence efforts by subscribers in subsequent closings and transferees in secondary market transfers of LP interests, and requests for contractual comfort with respect to the fund’s audit process.
- Understand fiduciary obligations on the tax representative as a result of the potential optionality of the new regime.
- Review state and local tax implications and developments.

Note that the Treasury Department has received a broad grant of authority and may issue guidance on a variety of issues, such as the impact on tiered structures (including master-feeder arrangements), basis computations, transitional rules, and the involvement of offshore feeders or investors.

Contact Information

If you have any questions regarding this alert, or the tax treatment of investment funds more generally, please contact:

Patrick B. Fenn
pfenn@akingump.com
212.872.1040
New York

Stuart E. Leblang
sleblang@akingump.com
212.872.1017
New York

Lewis J. Kweit
lkweit@akingump.com
212.872.1041
New York

Ron Grabov-Nardini
rgrabov-nardini@akingump.com
212.872.1079
New York

Howard Leventhal
hleventhal@akingump.com
212.872.1099
New York

Olivier De Moor
odemoor@akingump.com
212.872.1032
New York

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